The Economist explains

Why is supply-chain finance, as practised by Greensill Capital, risky?

Borrowing against unpaid invoices is vital for many firms, but it is an area of banking history littered with failures

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ON PAPER, supply-chain finance seems like a neat solution to a perennial problem. Companies are often paid by their customers late. One recent survey of small

manufacturers in Britain found that they receive payment, on average, nearly 35 days after they had delivered an order. And making those goods can consume a lot of cash. So specialist firms pay suppliers in advance, and then collect the payment due from their customer weeks later. Lately this corner of the financial world has been in the news, thanks to Greensill Capital. Founded just ten years ago, and once touted as having a market value of $7bn, the firm filed for insolvency in Britain earlier this month. Former clients, already struggling because of the pandemic, were left scrambling to find replacement financing at short notice. On March 18th Credit Suisse, an investment bank that included Greensill's loans in its funds, admitted that it may face litigation from its clients and a "material" hit to its results because of its links to the firm. What went wrong, and why is supply-chain finance so risky?

In theory shorter-term loans, such as those involved in most supply-chain finance, should be low-risk. It is much easier for a lender to guess how much cash a firm will have in a few weeks, when it is paid for an order, than at the end of a ten-year bank loan. But Greensill added more complexity. Like sub-prime mortgage firms before the global financial crisis, the startup sliced and diced its collection of bills and invoices, packaging them into bond-like investments. It then sold these to investors looking for juicier returns in a world of ultra-low bond yields (with extra profit for Greensill). A further twist was that many of these bonds were insured against the risk of default by the borrower. This reduced the cost of this sort of credit for firms. Credit Suisse filled one of its funds with $10bn of paper from Greensill. But when some of the companies that Greensill had lent to wobbled—unsurprisingly, given the toll on corporate balance-sheets taken by the pandemic—Credit Suisse froze its funds, heralding the collapse of Greensill. Investors soon refused to buy any more of its paper. Investors in Credit Suisse's funds had originally been insulated from the risk of any of the underlying companies defaulting by specialist credit insurers, who would refund investors in case of problems. But as risks piled on, those credit-insurers did not renew their cover, leaving investors exposed to companies whose business models—or whose very identity—they may not have understood.

Greensill liked to present itself as a financial innovator. Yet its model was a variation on an old idea. Britain's industrial revolution in the 19th century was

financed through a form of supply-chain finance. Firms raised funds to cover the cost of producing and shipping goods by selling bills of exchange, with the promise that they would be repaid on a certain date when payment for an amount of goods had been received. Initially these were sold to customers, family and friends of a firm who knew whether it could be trusted. But in the early 1800s a startup called Overend, Gurney & Co was the first financial firm to specialise in buying such bills, which it would pay for either by selling them on, or through borrowing by selling its own short-term debt. By the 1860s, when it had become the world's largest discounting house, its lax controls on whom it lent to brought on its collapse. Triggered by a court ruling saying Overend could not collect repayments from one of its debtors, its failure was the Lehman Brothers moment of the 1866 financial crisis. And it had 2008-sized consequences for the world economy, too. A fifth of banks headquartered in London were swept away in the ensuing panic, and global trade fell by 17%, according to Chenzi Xu of Harvard University.

Historians think that careless lending, clients who over-egged their assets or future income, and tightening credit conditions did for Overend. The full story of Greensill will take time to emerge. Its task of assessing creditworthiness may have been made harder by modern company accounts. It is easier to assess the value of tangible assets, such as loaves departing a 19th-century bakery, than intangible ones such as a website owned by a 21st-century firm. After the demise of Overend, credit-providers began to use more conservative accounting principles and predictions. There were then no systemic banking crises in Britain for more than a century. More caution, like that their forebears adopted, would do the reputation of modern supply-chain finance firms no harm.

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